

Briefing Book

FY2007 Consensus
Revenue Estimate Hearing
December 12, 2005

Massachusetts Department of Revenue

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FY05 Results

- FY05 tax collections totaled \$17.088 billion, up \$1.1 billion, or 7.1% from FY04.
- FY05 “baseline” tax collections (i.e., growth adjusted for the impact of tax law and administrative changes) were up 7.0%, compared to FY04.
- FY05 tax collections were \$437 million above the final FY05 revenue estimate of \$16.650 billion, primarily due to higher than projected capital gains tax collections, which totaled about \$1.215 billion in FY05, vs. an estimate of \$862 million. Capital gains taxes were up by about 40% in FY05 compared to FY04.
- FY05 saw modest improvement in withholding and sales tax collections:
 - FY05 baseline withholding collections increased 4.4%, compared with growth of 3.0% in the previous fiscal year;
 - FY05 baseline sales tax collections were up about 4.0%, compared with 2.2% in FY2004.
- Despite a sturdy national economy and improving state conditions, corporate and business collections weakened in FY05, declining by 1.3% baseline in FY05, compared with growth of 15.4% in FY04.

FY06 Summary

- **Assumptions For A&F 4/15/05 and 10/26/05 FY06 Estimates**
 - The A&F 4/15/05 FY06 estimate (\$17.500 billion before adjustment for subsequent tax law changes) assumed actual revenue growth of 5.3% and baseline revenue growth of 5.2% from FY05.
 - However, because FY05 revenue collections were \$437 million higher than assumed in the 4/15/05 FY06 estimate, the \$17.500 billion estimate was only 2.1% higher (2.5% higher in baseline terms) than FY05 actual collections.
 - Adjusted for tax law changes enacted by the time the FY06 budget was in place, the A&F 4/15/05 FY06 estimate was \$17.448 billion.
 - The General Appropriation Act assumed FY06 revenue collections of \$17.100 billion, before adding \$178 million for revenue initiatives and loophole closing actions. The \$17.100 billion estimate reflected actual growth of 0.8% and baseline growth of 0.4% from actual FY05 collections.
 - Baseline tax revenue growth was +8.3% in the first quarter of FY06 (\$194 million above the 4/15/05 YTD benchmark estimate corresponding to the A&F 4/15/05 FY06 forecast, adjusted for subsequent tax law changes). Consequently, on 10/26/05, the Executive Office of Administration and Finance increased the FY06 revenue estimate by \$509 million, to \$17.957 billion. The revised estimate reflects actual growth of 5.1% and baseline growth of 5.5%, similar to the original growth rates assumed in the 4/15/05 estimate.
 - The 10/26/05 A&F estimate assumed moderate economic growth in Massachusetts, with total revenues growing by 4.7% over the last 9 months of FY06. Over those 9 months, withholding was projected to grow by 5.0%, sales tax by 4.9%, and corporate/business tax by 5.7%. Capital gains realizations were assumed to grow by 10% in tax year 2005 (but only 6.3% based on actual 2004 tax return data, which were not available at the time of the 10/26 estimate), 6% in tax year 2006, and 5% in tax year 2007.

FY06 Summary

- **FY06 Results Through November 2005**
 - Total tax collections of \$6.670 billion, up \$435 million, or 7.0%, compared to the same period in FY05, \$4 million below the November year-to-date benchmark set out in the 10/26/05 revised revenue estimate.
 - YTD baseline growth rate of +7.3%, primarily due to very strong growth in corporate collections and income estimated payments, along with moderate growth in withholding and sales tax collections.
 - Year-to-date baseline withholding growth of 4.8%. With relatively modest employment growth, this suggests average wages were rising by around 4% during this period.
 - Corporate and business tax collections have strengthened recently, rising 43.4% baseline FY06 YTD. However, corporate collections are often volatile, and even more so in the first half of the fiscal year because the bulk of corporate tax payments are due between January and June and most refunds are processed in October and November.

FY06 Summary

- **Massachusetts Forecast for Remainder of Fiscal Year 2006 According to Moody's Economy.com, Global Insight and the New England Economic Partnership (NEEP)**
 - After stalling somewhat towards the end of 2005, economic conditions in the Bay State are expected to steadily improve during the second half of FY06. According to vendor forecasts, Massachusetts payrolls should expand between 1.0% and 1.4% in the second half of FY06. This compares with employment growth from 0.8% to 1.0% during the first half of FY06.
 - In line with an improving labor market early next year, Massachusetts wage and salary disbursements are expected to rise between 5.2% and 6.0% during the second half of FY2006, up from between 4.9% and 5.7% in the first half of the fiscal year. The vendor forecasts for employment and wages and salaries imply average wage growth somewhere between 3.9% and 5.0% during the second half of FY06. During the first two quarters of FY06, average wages are estimated to have grown 3.9% to 4.9%.
 - Economy.com forecasts that tax year 2005 capital gains realizations (which determine FY06 capital gains tax collections) will be about 20.5% higher than they were in tax year 2004.
 - Using economic projections from Global Insight, Economy.com, and the New England Economic Partnership (NEEP), total FY06 tax revenue is estimated to be \$17.953 billion to \$18.084 billion, \$195 million to \$326 million above the A&F October 2005 FY06 estimate adjusted for tax law changes enacted in November 2005. DOR believes it would be prudent to reduce the FY06 forecasts by \$75 million to account for uncertainty in forecasting capital gains taxes.

FY07 Summary

- **Fiscal Year 2007 (According to Economic Forecasters)**
 - Spurred by moderating energy prices, national economic activity is expected to remain relatively strong through the first half of fiscal year 2007. By the second half of FY07, however, economic growth will moderate as rising interest rates and a cooling housing market begin to place a drag on the economy.
 - During the first half of FY07, the Massachusetts economy is expected to perform relatively well, but will still lag the national economy. In particular, with energy prices moderating, consumer spending should be more robust at the start of the winter heating season. Growth will then moderate through the second half of FY07 as rising interest rates and a softening housing market begin to weigh on economic activity.
 - Massachusetts employment is expected to grow 0.9% to 1.2% compared with FY06;
 - Massachusetts wages and salaries are expected to increase 5.1% to 5.5% compared with FY06, implying average wage growth somewhere between 4% and 4.6%;
 - Massachusetts personal income is expected to rise 4.4% to 5.9% compared with FY06;
 - Nationally, corporate profits are expected to weaken with forecasts of a decline of 1.2% to growth of 2.3%, compared with FY06.
 - Using growth assumptions from Global Insight, Economy.com, and the New England Economic Partnership (NEEP), FY07 tax revenue is projected to be \$19.028 billion to \$19.070 billion, reflecting baseline growth of 5.0% to 5.7% over FY06. However, DOR believes it would be prudent to reduce the FY07 estimates by \$150 million to account for uncertainty in forecasting capital gains taxes.

Recent Revenue Trends

- **Two Measures of Tax Revenue Growth:**
 - Actual growth - growth in actual collections over two periods.
 - Baseline growth - growth had there been no tax law or administrative changes that affected tax collections. Baseline growth also adjusts for fluctuations in the timing of tax collections. Baseline growth is a better measure of the change in the underlying tax base and the economy.

	11/05 YTD Collections	11/05 YTD \$ Change	11/05 YTD Actual % Change	11/05 YTD Baseline % Change
Total Income	3,688	195	5.6%	6.6%
Income Withholding	3,191	130	4.3%	4.8%
Income Est Payments (Cash)	472	54	13.0%	17.7%
Income Returns/Bills	159	24	17.6%	15.2%
Income Refunds (Cash)	137	12	9.5%	8.0%
Sales & Use	1,706	70	4.3%	4.3%
Corporate & Business	531	167	45.7%	43.4%
All Other	745	4	0.5%	(0.8%)
Total Tax Collections	6,670	435	7.0%	7.3%

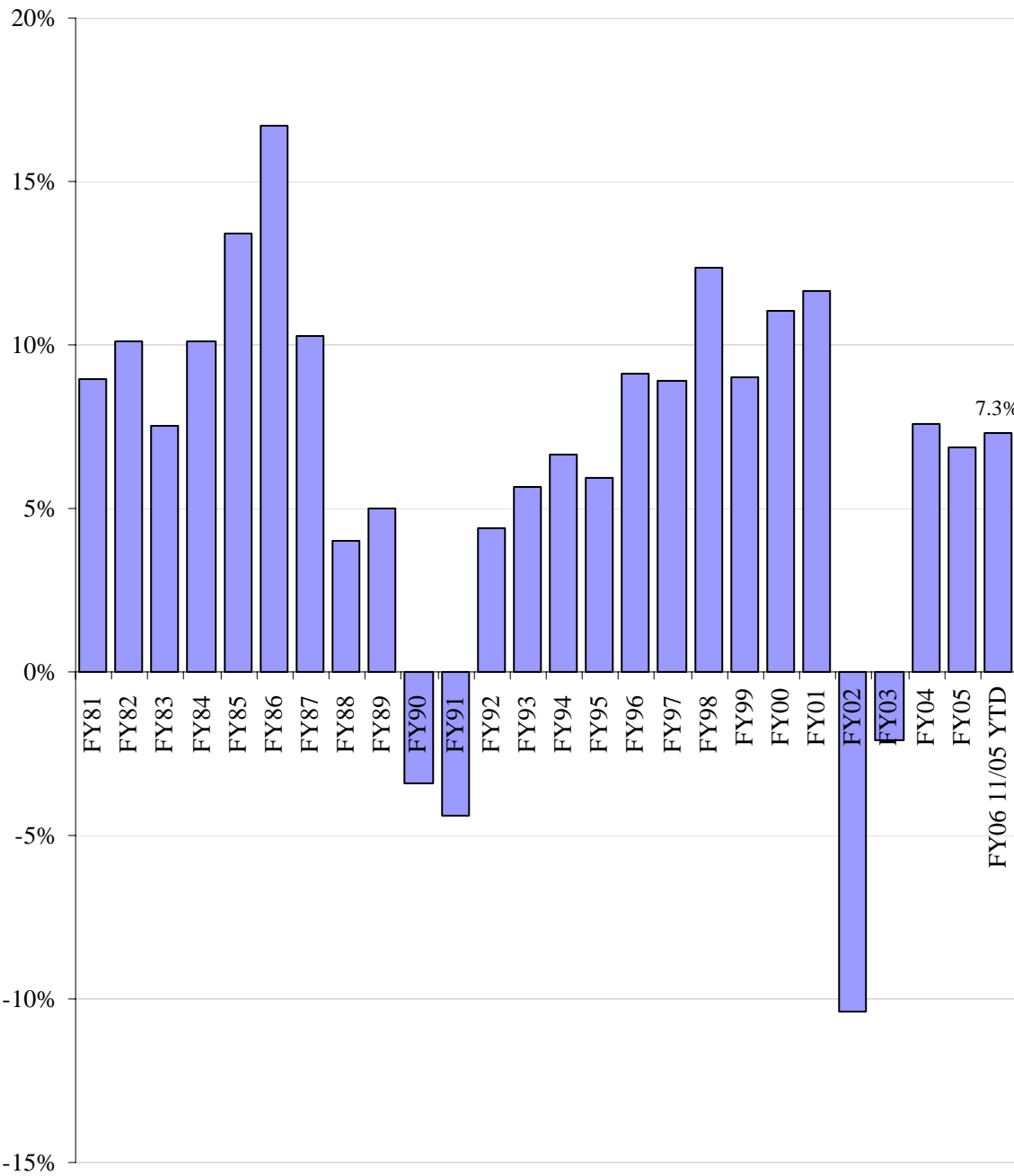
Note: Detail may not add to total due to rounding and other technical factors

Recent Revenue Trends

- **Withholding**
 - Baseline withholding growth has been steady, moving in a narrow range of 4.0%-5.5% growth since the start of CY2005. Given the moderate nature of recent employment growth, most of the withholding gains are the result of higher average wages.
 - Bonus season is just starting, which will affect withholding collections from December 2005 through March 2006. The recent strength in the stock market and in corporate profits portends a healthy bonus season in the financial services sector.
- **Income Tax Estimated Payments**
 - Growth in estimated payments has remained at elevated levels through CY2005. This suggests that unincorporated business conditions remain favorable and that capital gains continue to be strong.
- **Sales Tax**
 - Although total sales tax collections have weakened recently, this is largely a reflection of a sharp drop in automobile sales. Strength in meals and tangible property sales tax collections helped net baseline collections increase by 4.3% FY06 YTD.
- **Corporate and Business Excise**
 - The corporate environment has remained healthy during the past twelve months, which has been reflected in solid corporate and business tax revenue growth through the start of FY06.

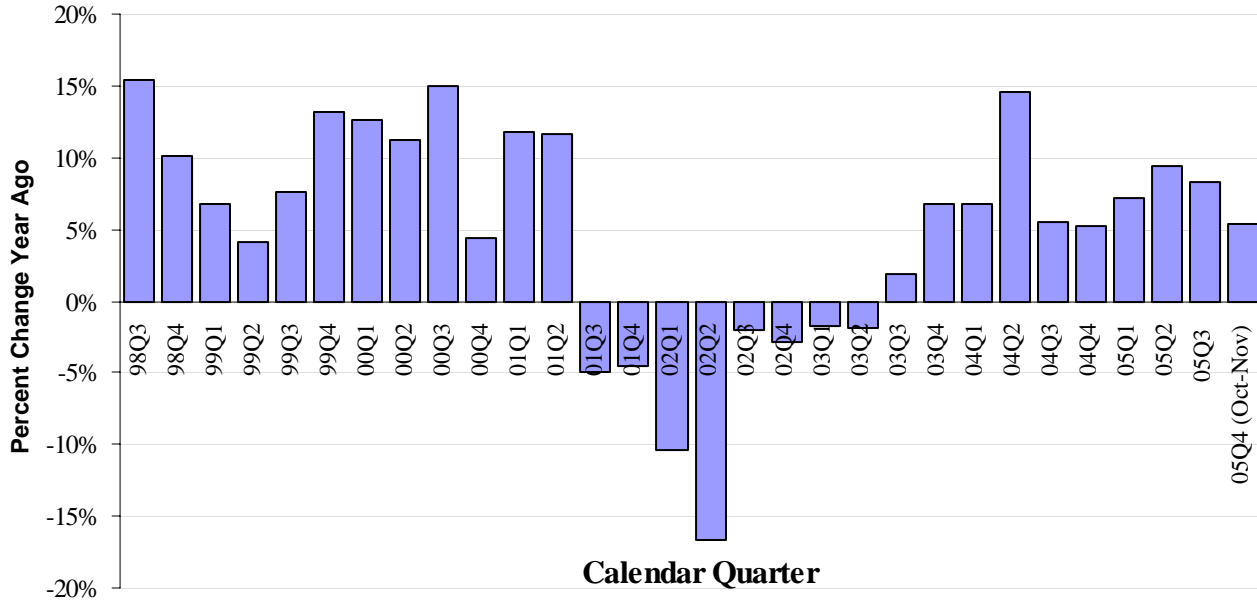
Recent Revenue Trends

Baseline Tax Revenue Growth, FY1981-FY2006

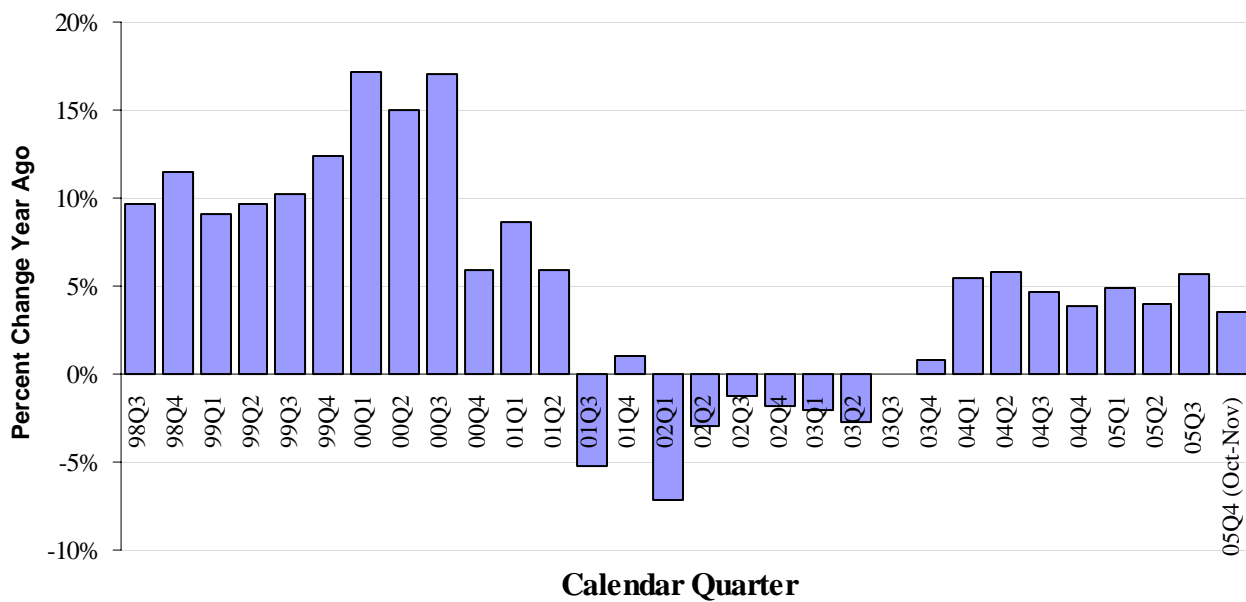


Recent Revenue Trends

Quarterly Baseline Total Tax Growth, FY99-FY06

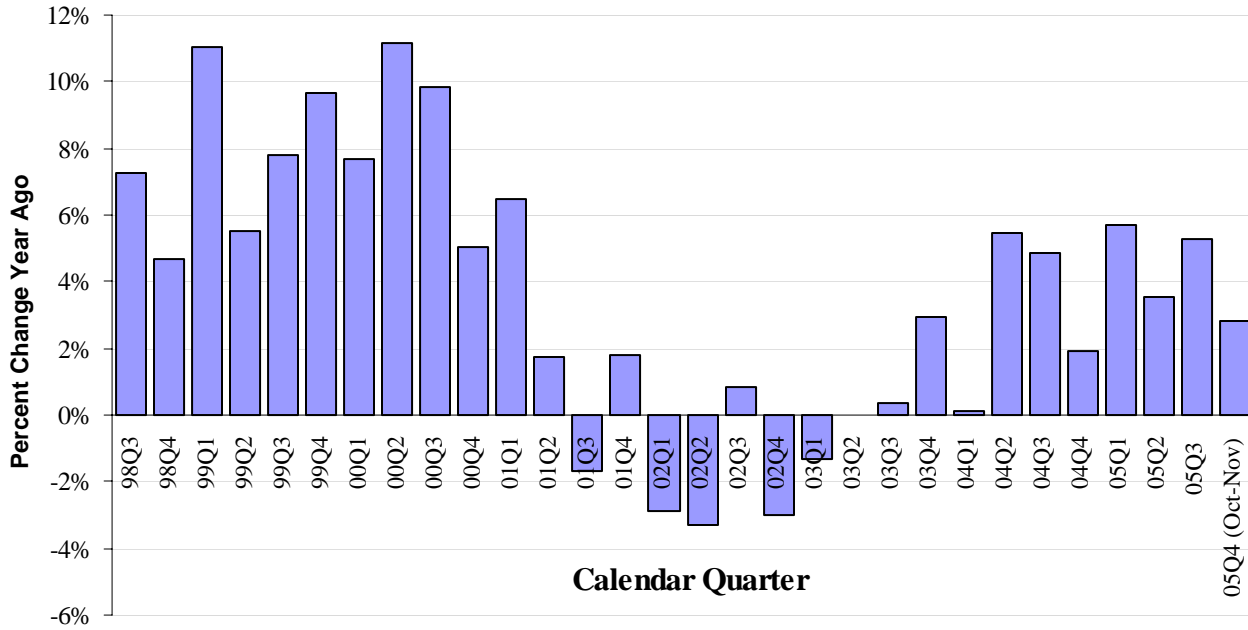


Quarterly Baseline Withholding Growth, FY99-FY06

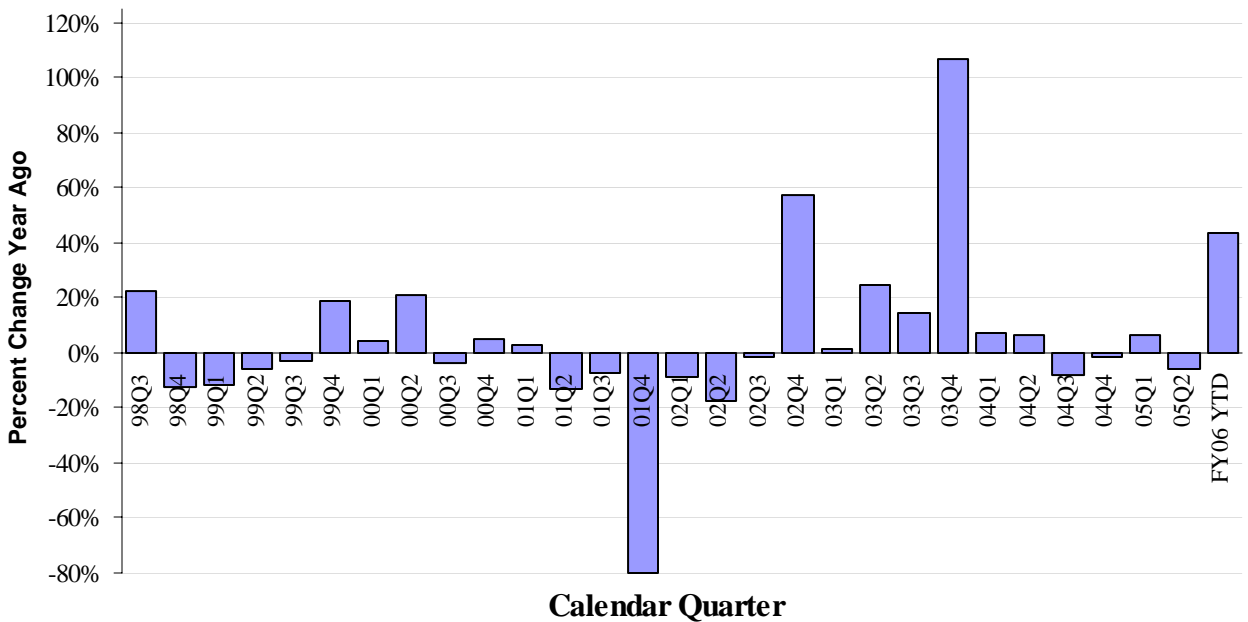


Recent Revenue Trends

Quarterly Baseline Sales Tax Growth, FY99-FY06



Quarterly Baseline Corporate/Business Tax Growth, FY99-FY06



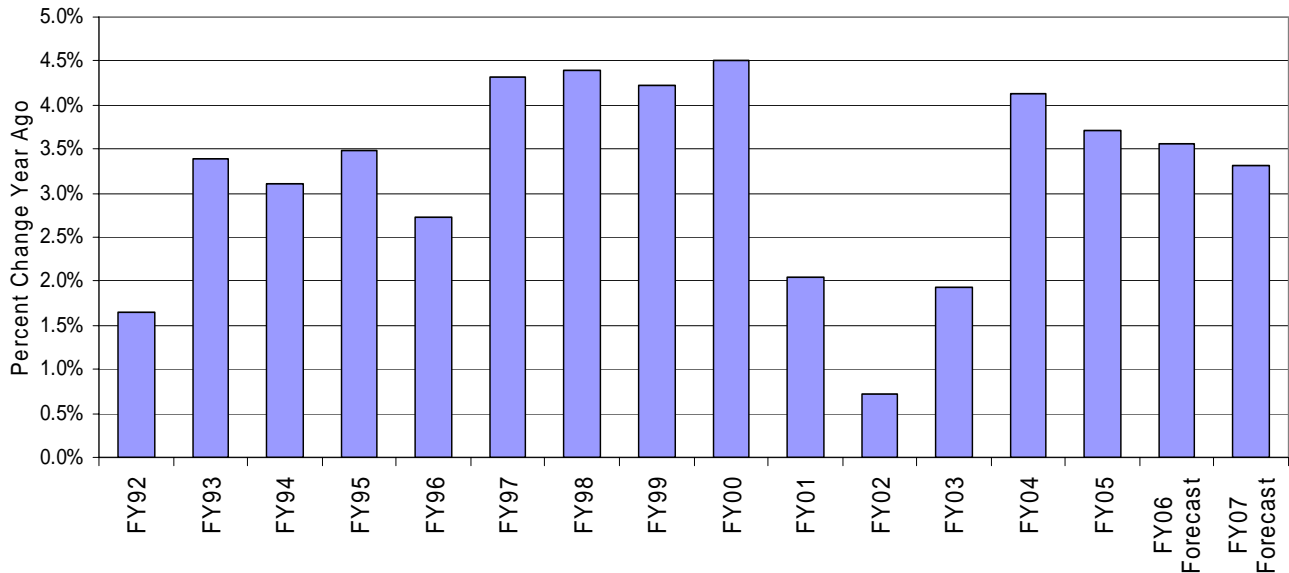
The U.S. Economy

- DOR utilizes national and Massachusetts state forecasts from Global Insight, Moody's Economy.com, and the New England Economic Partnership (NEEP).
- Despite rising energy prices and the devastating effects of the Gulf Coast hurricanes, the national economy has performed relatively well. In the third quarter of 2005, real GDP is estimated to have grown by 4.3%, up from 3.3% during the previous quarter.
- The national labor market has exhibited solid growth during the past year. Even including the severe job losses associated with the recent hurricanes, US employment rose 1.4% on a year-over-year basis during October 2005 and added 215,000 jobs in November.
- The underlying resilience of the US economy is being reflected in the stock market. The S&P500 stock price index was up 11% on a year-over-year basis in the third quarter of 2005 and has risen by 42% from its lowest point in the first quarter of 2003.
- After 12 successive increases since mid-2004, the Federal Funds rate now stands at 4%. Although core inflation has yet to show convincing signs of any pass through from high energy prices, it is expected that the Federal Reserve will continue to raise its benchmark rate into 2006. Longer-term interest rates have started to move up recently and this trend should lead to a softening of the housing market during the coming year.
- DOR's economic forecasters are predicting the US economy will continue to grow steadily during much of 2006 and then moderate in 2007 due to higher interest rates and a cooling housing market. After advancing by an estimated 3.6% in 2005, Gross Domestic Product (GDP) is expected to grow between 3.4% and 3.7% in 2006 and 2.9% and 3.1% in 2007.

The U.S. Economy

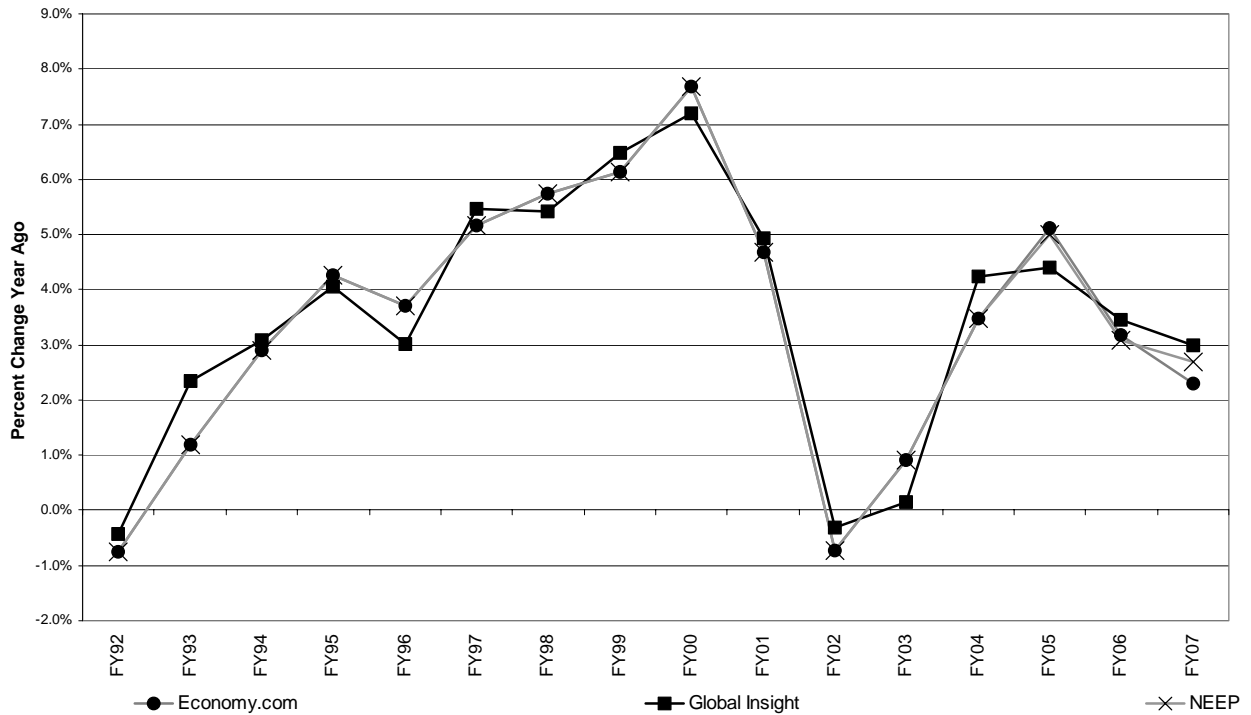
Real GDP Growth FY1992-07

(Average of Economy.com and Global Insight 11/05 forecasts, beginning FY06)



Massachusetts Real GSP Growth FY1992-07

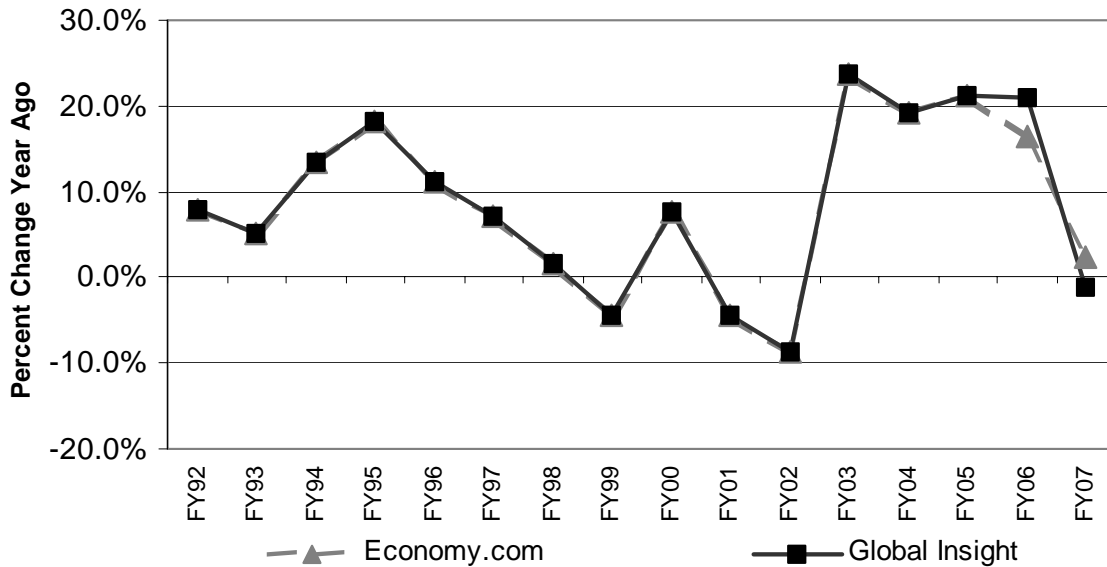
(Forecasts begins in CY 2005)



The U.S. Economy

Growth in Business Profits is Expected to Slow Markedly

(Corporate Profits Before Tax FY1992-07)



Interest Rates Will Continue to Rise Through FY07

(Bank Prime Rate)



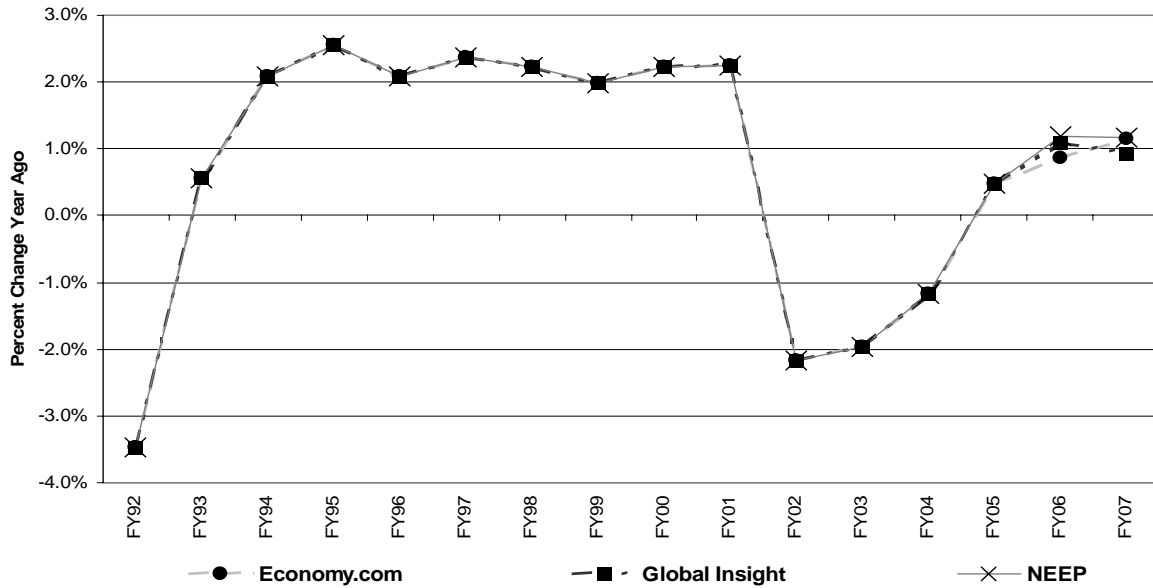
The Massachusetts Economy

- Buffeted by rising interest rates and energy prices, the Massachusetts economy softened towards the end of 2005. According to the “Massachusetts Benchmarks” publication, the Bay State economy has slowed noticeably between the middle of 2004 and the third quarter of 2005. Further evidence of this trend is seen in the Federal Reserve Bank of Philadelphia’s economic activity index, which shows a slowing in Bay State economic growth since early 2005.
- Mirroring a softening economic environment, Bay State employment contracted during August, September and October. The most recent payroll report shows payrolls falling by 7,100 in October 2005, leaving the state economy with a net gain of only 400 jobs during the prior six months. On a year-over-year basis October employment growth stood at 0.5%, down from 0.9% in September 2005. The unemployment rate registered 4.8% in October, unchanged from September and slightly above the 4.7% rate in December 2004.
- There is growing evidence that the state’s housing market is beginning to cool. According to the Massachusetts Association of Realtors, sales of single family homes fell 9.1% year-over-year during October 2005, with the median price advancing 1.2% during the same period. Although condo sales and prices did perform better, inventory in both categories has risen from year-ago levels hinting again at a softening market.
- Economic conditions in the Bay State are expected to improve during early 2006, although growth will remain moderate and continue to lag the nation.

The Massachusetts Economy

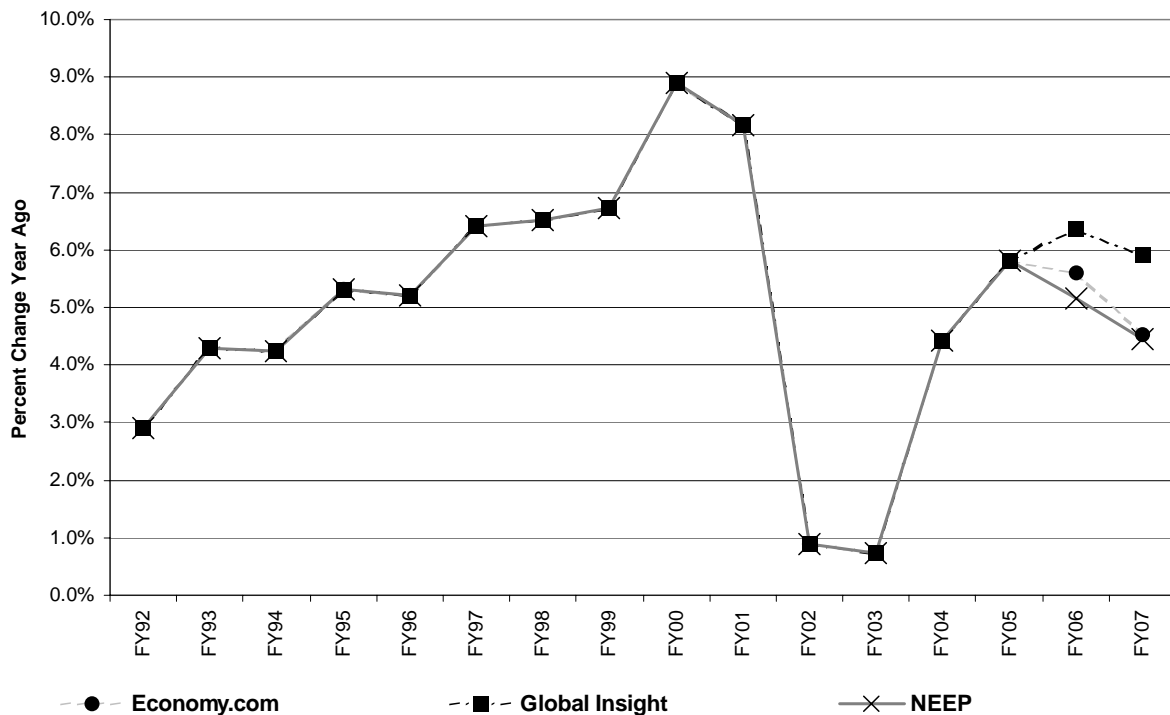
Massachusetts Employment Forecasts

(Forecast begins in FY06)



Massachusetts Personal Income Forecasts

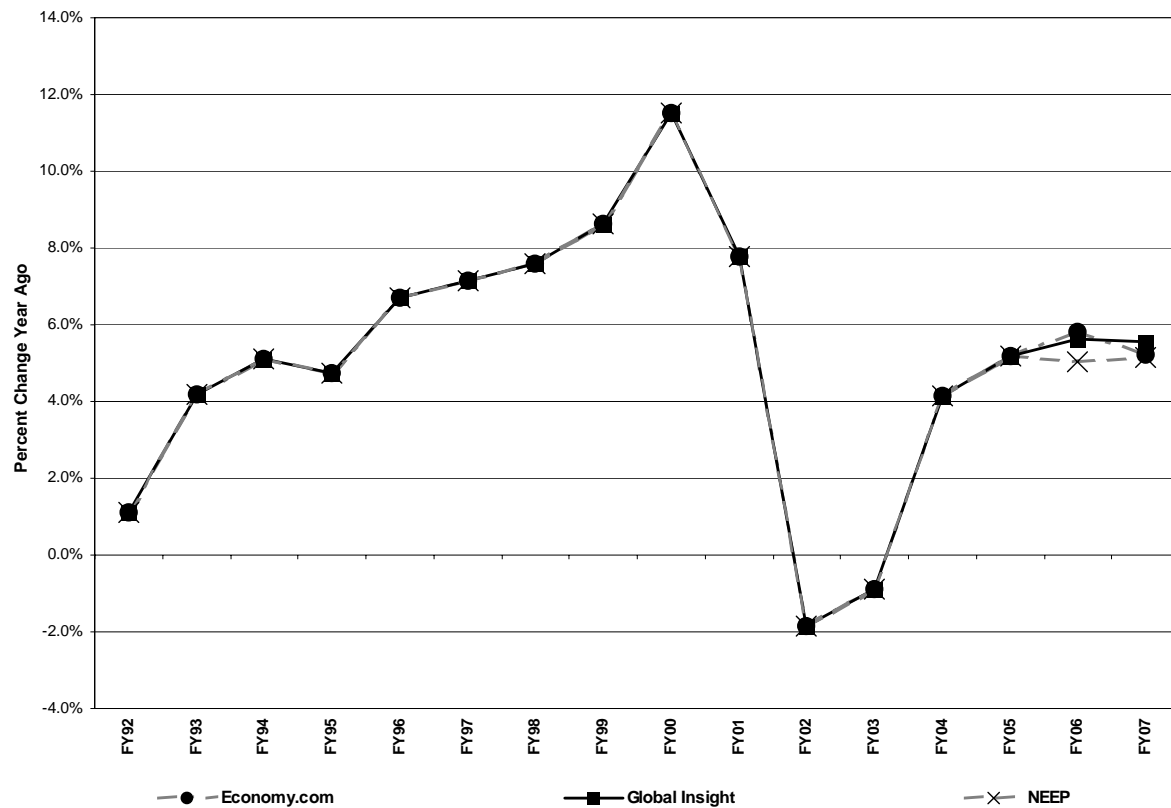
(Forecast begins in FY06)



The Massachusetts Economy

Massachusetts Wages and Salaries Forecasts

(Forecast begins in FY06)



Massachusetts Economic Forecast Table

(Percent Change from Prior Fiscal Year)

	History			Forecast			
	FY 2003	FY 2004	FY 2005	FY2006 <i>First Two Quarters</i>	FY2006 <i>Last Two Quarters</i>	FY2006 Full Fiscal Year	FY2007
<u>US - Global Insight 11/05</u>							
Real GDP	1.9%	4.1%	3.7%	3.5%	3.5%	3.5%	3.2%
Corporate Profits	23.8%	19.1%	21.3%	35.9%	9.4%	20.9%	-1.2%
S&P 500 (Calendar Year Growth)	-3.2%	17.3%	6.6%	NA	NA	5.3%	1.8%
Unemployment Rate	5.9%	5.8%	5.3%	5.0%	4.9%	4.9%	4.8%
<u>US - Economy.com 11/05</u>							
Real GDP	1.9%	4.1%	3.7%	3.5%	3.7%	3.6%	3.5%
Corporate Profits	23.8%	19.1%	21.3%	32.8%	3.9%	16.4%	2.3%
S&P 500 (Calendar Year Growth)	-3.2%	17.3%	7.5%	NA	NA	6.8%	4.5%
Unemployment Rate	5.9%	5.8%	5.3%	5.1%	5.0%	5.1%	4.9%
<u>Massachusetts - Global Insight 11/05</u>							
Real GSP	0.2%	4.2%	4.4%	3.5%	3.4%	3.4%	3.0%
Wages & Salaries	-0.9%	4.2%	5.2%	5.4%	5.8%	5.6%	5.5%
Personal Income	0.7%	4.4%	5.8%	5.8%	6.9%	6.4%	5.9%
Employment	-2.0%	-1.2%	0.5%	1.0%	1.2%	1.1%	0.9%
Retail Sales	0.8%	5.9%	6.9%	6.2%	4.3%	5.2%	4.4%
Unemployment Rate	5.6%	5.6%	4.8%	4.6%	4.5%	4.5%	4.5%
Housing Starts	-6.0%	26.4%	9.9%	2.4%	-21.8%	-10.1%	-18.9%
<u>Massachusetts - Economy.com 11/05</u>							
Real GSP	0.9%	3.5%	5.1%	3.8%	2.6%	3.2%	2.3%
Wages & Salaries	-0.9%	4.2%	5.2%	5.7%	6.0%	5.8%	5.2%
Personal Income	0.7%	4.4%	5.8%	5.5%	5.7%	5.6%	4.5%
Employment	-2.0%	-1.2%	0.5%	0.8%	1.0%	0.9%	1.1%
Retail Sales	4.6%	4.3%	6.7%	5.6%	3.3%	4.4%	4.0%
Unemployment Rate	5.6%	5.6%	4.8%	4.7%	4.6%	4.6%	4.5%
Housing Permits	-2.8%	25.7%	15.0%	-4.8%	-20.6%	-13.1%	-15.1%
Home Sales	-1.4%	7.5%	7.1%	-7.7%	-7.0%	-7.4%	-10.0%
<u>Massachusetts - NEEP 11/05</u>							
GSP (real)	0.9%	3.5%	5.0%	3.2%	3.0%	3.1%	2.7%
Wages & Salaries	-0.9%	4.2%	5.2%	4.9%	5.2%	5.0%	5.1%
Personal Income	0.7%	4.4%	5.8%	5.0%	5.3%	5.1%	4.4%
Employment	-2.0%	-1.2%	0.5%	1.0%	1.4%	1.2%	1.2%
Retail Sales	4.6%	4.3%	6.7%	5.6%	3.3%	4.4%	4.0%
Unemployment Rate	5.6%	5.6%	4.8%	4.5%	4.4%	4.4%	4.4%
Housing Permits	-2.8%	25.7%	12.5%	-9.7%	-16.6%	-13.2%	-15.0%

FY06 & FY07 Tax Revenue Projections

FY06 and FY07 Tax Revenue Projections Based on Assumptions of Moody's Economy.com, Global Insight, and the New England Economic Partnership
(in \$ Billions)

	FY06 Projections	\$ Growth from FY05	% Growth Actual from FY05	% Growth Baseline from FY05	FY07 Projections	\$ Growth from FY06	% Growth Actual from FY06	% Growth Baseline from FY06
A&F 10/26/05*	\$17.957	\$0.869	5.1%	5.5%	\$18.678	\$0.721	4.0%	4.1%
<i>Post 10/26/05 Law Changes</i>	(\$0.199)				(\$0.074)			
A&F 10/26/05 After Subsequent Law Changes	\$17.758	\$0.670	3.9%	5.5%	\$18.604	\$0.846	4.8%	4.1%
Economy.com**	\$17.953	\$0.865	5.1%	6.6%	\$19.028	\$1.075	6.0%	5.6%
<i>Adjustment for Capital Gains Risk</i>	(\$0.075)				(\$0.150)			
Economy.com Net of Capital Gains Adjustment	\$17.878	\$0.790	4.6%	6.2%	\$18.878	\$1.000	5.6%	5.2%
NEEP**	\$17.978	\$0.890	5.2%	6.8%	\$19.070	\$1.093	6.1%	5.7%
<i>Adjustment for Capital Gains Risk</i>	(\$0.075)				(\$0.150)			
NEEP Net of Capital Gains Adjustment	\$17.903	\$0.815	4.8%	6.3%	\$18.920	\$1.018	5.7%	5.3%
Global Insight**	\$18.084	\$0.996	5.8%	7.4%	\$19.066	\$0.982	5.4%	5.0%
<i>Adjustment for Capital Gains Risk</i>	(\$0.075)				(\$0.150)			
Global Insight Net of Capital Gains Adjustment	\$18.009	\$0.921	5.4%	7.0%	\$18.916	\$0.907	5.0%	4.7%

* Does not include tax law changes subsequent to 10/26/05 that are estimated to reduce FY06 tax collections by \$199 million and FY07 tax collections by \$74 million.

** Includes tax law changes subsequent to 10/26/05 that are estimated to reduce FY06 tax collections by \$199 million FY07 tax collections by \$74 million.

FY06 & FY07 Tax Revenue Projections

FY06 Year-To Date Baseline Growth; Forecasts for Remainder of FY06 and FY07

	FY06 YTD Baseline Growth	Baseline Growth Remainder of FY06			FY07 Baseline Growth		
		<u>Economy.com</u>	<u>NEEP</u>	<u>Global Insight</u>	<u>Economy.com</u>	<u>NEEP</u>	<u>Global Insight</u>
Income Total	6.6%	8.6%	8.8%	9.2%	8.3%	8.3%	8.4%
<i>Income Withholding</i>	4.8%	5.7%	5.9%	5.8%	4.9%	5.0%	5.1%
Sales - Regular	5.5%	4.9%	4.9%	5.7%	3.4%	3.4%	3.3%
Sales - Meals	3.6%	5.7%	5.7%	5.7%	5.1%	5.0%	5.2%
Sales - Motor Vehicle	-0.4%	-0.9%	-0.9%	-0.9%	7.5%	7.3%	2.1%
Sales - Total	4.3%	4.1%	4.1%	4.7%	4.3%	4.2%	3.4%
Corporate & Business	43.4%	6.1%	6.9%	13.3%	-2.1%	-1.4%	-5.1%
Other Tax Revenue	2.7%	-2.3%	-2.3%	-3.7%	1.7%	1.7%	1.3%
Total Tax Revenue	7.3%	6.3%	6.5%	7.5%	5.6%	5.7%	5.0%

FY06 & FY07 Tax Revenue Projections

FY05 Actual Tax Revenue Collections, FY06 and FY07 Tax Revenue Forecasts (in \$ millions)

	----- FY 2006 -----						----- FY 2007 -----				
	FY05 Actual	10/26/05 A&F*	10/26/05 A&F After Tax Law Changes**	Economy.com**	NEEP**	Global Insight**	10/26/05 A&F*	10/26/05 A&F After Tax Law Changes**	Economy.com**	NEEP**	Global Insight**
Withholding	7,674	8,029	8,029	8,047	8,011	8,052	8,393	8,393	8,389	8,404	8,407
Other Income	2,016	2,194	1,982	2,117	2,166	2,148	2,339	2,213	2,659	2,663	2,688
Total Income	9,690	10,224	10,011	10,164	10,177	10,200	10,733	10,606	11,048	11,067	11,095
Sales: Regular	2,747	2,874	2,886	2,887	2,887	2,900	2,997	3,047	3,020	3,020	3,030
Sales: Meals	556	581	581	582	582	582	610	610	612	611	612
Sales: Motor Vehicles	584	613	613	580	580	580	644	644	624	622	593
Sales Total	3,886	4,068	4,080	4,049	4,049	4,062	4,250	4,300	4,256	4,253	4,235
Corporate & Business	1,706	1,908	1,908	1,964	1,976	2,062	1,907	1,907	1,923	1,948	1,957
Other Tax Revenue	1,806	1,757	1,757	1,776	1,776	1,760	1,788	1,788	1,801	1,802	1,779
Total Tax Revenue	17,088	17,957	17,758	17,953	17,978	18,084	18,678	18,604	19,028	19,070	19,066
MBTA	705	713	713	713	713	713	734	738	734	734	734
SMART Fund	396	489	490	485	485	487	568	576	569	568	565
Total for Budget	15,987	16,756	16,555	16,755	16,780	16,884	17,376	17,290	17,726	17,768	17,767
Note: Capital Gains***	1,215	1,234	1,234	1,425	1,425	1,425	1,299	1,299	1,784	1,784	1,784

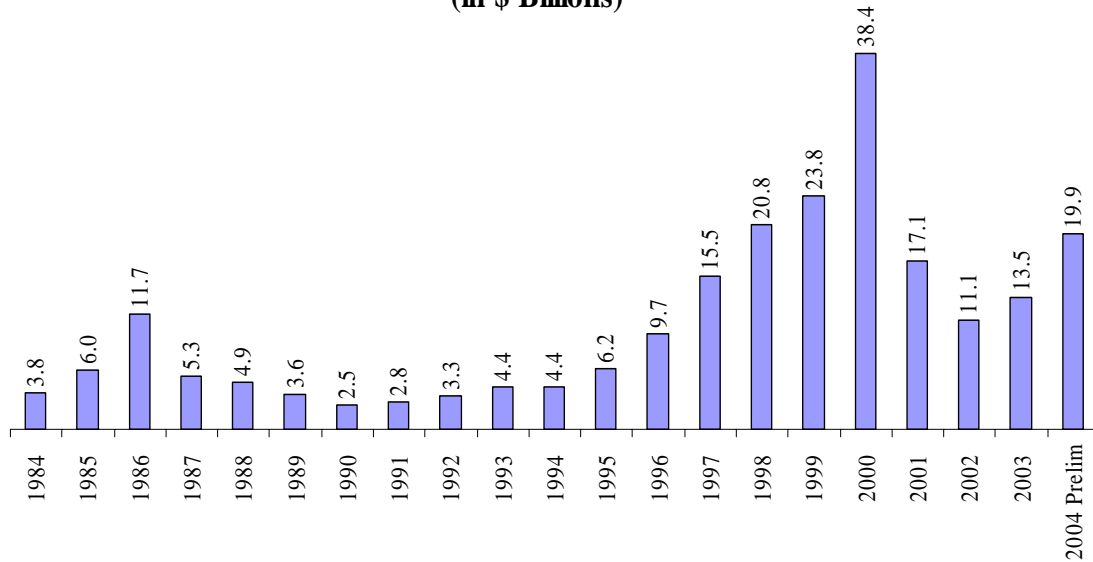
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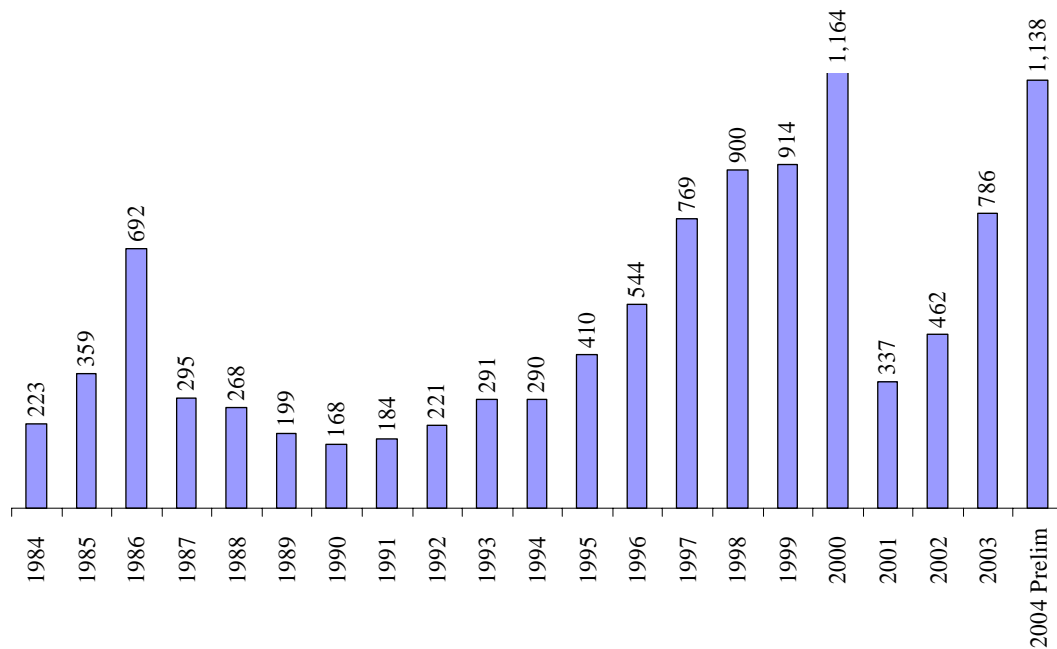
*** Economy.com is the only forecast vendor that forecasts capital gains - Economy.com capital gains forecasts are used for Global Insight and NEEP.

Capital Gains Taxes

MA Taxable Capital Gains Realizations, Tax Year Basis
(in \$ Billions)



MA Taxable Capital Gains Tax Collections, Tax Year Basis
(in \$ million)



Capital Gains Taxes

- Preliminary income tax return data for tax year 2004 indicate that 2004 capital gains realizations were \$19.9 billion, versus \$13.5 billion in tax year 2003, an increase of 47%.
- Capital gains taxes grew from \$786 million in tax year 2003 to approximately \$1.138 billion in tax year 2004 (2004 numbers are still preliminary), an increase of \$352 million, or 45%. On a fiscal year basis, FY05 capital gains taxes probably totaled about \$1.215 billion (though no exact numbers are available), \$346 million, or 40% higher than FY04.
- The 10/26/05 A&F estimate assumed that tax year 2005 capital gains realizations would increase by 10% over 2004, and that tax year 2006 realizations would increase by 6% over tax year 2005.
- Economy.com (the only economic forecaster that estimates state capital gains realizations) estimates that in tax year 2005 taxable Massachusetts capital gains realizations will grow by 20.5% compared to 2004, tax year 2006 realizations will grow by 29.3% compared to 2005, and tax year 2007 realizations will decline by 14.8% compared to 2006. Because Economy.com is the only forecaster that estimates capital gains, their projections were used in generating all three vendors' tax revenue forecasts.
- The Economy.com capital gains forecast implies tax year 2005 capital gains taxes of \$1.358 billion, and tax year 2006 capital gains taxes of \$1.737 billion. On a fiscal year basis, capital gains taxes would be approximately \$1.425 billion in FY06 and \$1.784 billion in FY07. Given the difficulty in forecasting capital gains taxes, DOR believes it would be prudent for budgeting purposes to reduce the estimates by \$75 million in FY06 and \$150 million in FY07.